Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF LATVIA	Assigned Ratings/Outlook: **A /stable**	Type: Monitoring, unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	26-08-2016 26-06-2020 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 26 June 2020

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "A" for the Republic of Latvia. Creditreform Rating has also affirmed Latvia's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A". The outlook remains stable.

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Key Rating Drivers

1. Accelerating income convergence on the back of robust growth prior to Covid-19 outbreak; while the Covid-19 pandemic significantly dampens medium-term prospects as regards economic growth and labor market conditions, we expect Latvia's economy to recover through the second half of the year, presuming that there is no second infection wave; forecasts subject to unusually high degree of uncertainty
2. Structural impediments continue to challenge the sovereign's macroeconomic profile, with rapidly declining working age population prospectively curbing productivity growth, and cost competitiveness remaining a viable threat to the economy's resilience; track record of high macro-financial volatility
3. Quality of institutional set-up remains generally high despite underperforming rating peers; institutional setting supported by EU/EMU membership; despite increasingly fragmented political landscape, effective and highly responsive policy-making, as demonstrated by swift reaction to Covid-19 and ongoing efforts in terms of AML/CFT
4. Public finances likely to deteriorate markedly due to plunging tax revenues and extensive Covid-19 aid measures; however, fiscal risks largely mitigated by highly affordable debt backed by low financing costs and high investor demand, a favorable fiscal starting position so that public debt ratio is likely to remain comparatively low, as well as by a track record of fiscal discipline and prudent debt management
5. Vulnerability to external shocks remains high, but external risks seem to subside, as reflected by further declining external debt and an improving, though still large and negative, net international investment position; current account should remain more or less balanced this year

Reasons for the Rating Decision

Creditreform Rating has affirmed the Republic of Latvia's ratings, which are mainly backed by sound fiscal policy-making and favorable fiscal metrics as well as by a generally high institutional quality, while macroeconomic performance continues to be somewhat dampened by relatively low per capita incomes, a high degree of macro-financial volatility, and demographic challenges.

Macroeconomic Performance

The outbreak of Covid-19 has had devastating effects on the short-term outlook of the Latvian economy, and entails significant uncertainty with respect to medium-term growth. The events around Covid-19 aside, we assess Latvia's macroeconomic performance as generally favorable, with relatively low though increasing per capita incomes complemented by solid medium-term economic growth. Structural impediments continue to represent key credit constraints, weighing on the country's economic prospects in the medium to long term, namely a track record of high volatility of macro-financial variables and demographic challenges which result in a significantly declining labor force. Together with the tight labor market, this is putting pressure on wages, which are not matched by productivity increases, thus putting cost competitiveness at risk.

Before the crisis hit, Latvia's real GDP growth had decelerated to 2.2% in 2019. Though still growing at a pace well above the euro area average (1.3%), this was half the previous year's outturn, when the Latvian economy expanded by 4.3%. What is more, Latvia fell behind its Baltic peers Estonia and Lithuania, which proved more resilient in a challenging international environment (4.3% and 3.9% respectively). The slowdown was largely driven by easing domestic demand.

In particular, investment growth disappointed after two years of double-digit growth. After having leapt by 11.3% and 15.8% in 2017/18, gross fixed capital formation (GFCF) increased by only 3.0% last year, contributing only 0.7 p.p. to growth. While lower investment growth to some extent also mirrors the maturing EU structural funding cycle, investment was mainly dragged down by weaknesses in manufacturing, essentially energy production, wood processing, and construction. Growth in total construction investment fell markedly, from 19.9% to 2.8% in 2018-19, and growth in machinery and equipment investment nosedived to 2.0% (2018: 13.1%). This also had a bearing on employment, which came to a standstill in 2019 (-0.1%, national accounts data, domestic concept) after having risen by 1.6% a year before. Accordingly, private consumption also grew less rapidly than in the previous year, at 2.9% vs. 4.2% in 2018, whilst still being aided by vivid wage growth, with average monthly gross wages increasing by 7.2%, close to the annual average of 7.0% seen in 2015-18.

On the other hand, net external trade proved to be less of a drag on economic growth, indicated by a growth contribution of -0.3 p.p. as compared to -1.7 p.p. in 2018, as the heavy, investment-induced decline in import growth was more pronounced than that of exports. Being somewhat cushioned by the persistent strength of services exports, overall

export growth softened to 1.9% amidst weakening global manufacturing, ongoing trade tensions and continued Brexit uncertainties.

Looking forward, we expect that the Latvian economy will suffer significantly from the outbreak of the coronavirus, and would pencil in a harsh contraction to the tune of 8.0%. With a view to the following year, we cautiously forecast total output to rebound by 6.2%, implying that it will take at least up to the end of 2021 before lost output is completely recovered. We have to highlight that our underlying baseline scenario, which assumes the economic fallout to be concentrated in Q2, is subject to an unusually high degree of uncertainty, as it is highly dependent on the further development of the Covid-19 pandemic, i.e. whether there is a second wave.

The first cases of the novel virus appeared in Latvia at the beginning of March, and on 12 March a state of emergency was declared, leading to a far-reaching standstill in Latvia's social and economic life. As authorities apparently have been quite successful in limiting the spread of Covid-19, authorities began to gradually ease the restrictions on 12 May. The state of emergency ended on 09 June. Whilst measures appeared to be somewhat less restrictive than in other European economies, the impact of the shutdown and adverse repercussions from the external environment will be harsh.

The Q1 national accounts data outturn, in this vein, hints at the economic damage that will see the Latvian economy slide into a hard, though short recession. Despite the fact that the lockdown was initiated as late as mid-March, real GDP dropped by 1.5% y-o-y, the steepest fall since the Great Financial Crisis. This was largely attributed to the weak performance in transport and financial services, but also to Covid-19, prompting household spending to fall substantially by 3.8% (s.a.).

Private consumption data are a harbinger for the significant decline we expect for the current year. Household spending should collapse in the context of the distancing measures seized, restrictions in the services sector, and travel bans imposed in the first half of the year. Consumer confidence plummeted in March and April respectively, to levels last seen back in 2010, reflecting the tremendous uncertainty weighing on consumers' spending behavior.

Consumption will also be dented by decreasing disposable incomes and weakening labor market conditions. The Latvian labor market had continued to develop favorably in 2019, with the unemployment rate continuing on its downward trajectory, decreasing from 7.4% in 2018 to 6.3% in 2019. Yet, Covid-19 has already left its mark on Q1 data, as the LFS-adjusted unemployment rate jumped to 6.9% in Q1-20 (Q4-19: 6.0%, Eurostat data). Labor market conditions deteriorated further in April, with unemployment shooting up further from 7.4 in March to 9.0% this April. According to the Ministry of Finance, 5.0% of the economically active population received downtime benefits since the beginning of the crisis up to 25 May.

In order to contain the economic consequences of the Corona pandemic, the government adopted a raft of measures geared towards ensuring corporate liquidity, thus preventing wide-spread insolvencies, securing employment, and protecting vulnerable groups. Hence, we expect the labor market, as well as private consumption, to recover relatively quickly as

the worst Covid-19 effects are likely to be cushioned by the government's policy response, including support in the field of taxes and benefits (see below), which is likely to offer some relief to households. In addition, the Minimum Income Level Introduction Plan for 2020-2021, which was approved by the government last year and came into force in January 2020, may also lend some support. In mid-June, the government introduced a law which provides for the subsidization of wages by a maximum of 50% for three months for newly-hired employees, which may prove beneficial in jump-starting employment growth. Hence, government consumption should display vigorous growth this year.

Although the government intends to ramp up public investment and the Q1 outturn for overall investment growth was reasonably good (+4.3% y-o-y), we expect that overall investment activity will take an even bigger hit than consumption, as corporates are confronted with an unprecedented sudden shock that affects both supply and demand. Despite government efforts to aid businesses by granting loans, as well as loan and portfolio guarantees, operating surpluses and profit margins will inevitably be jeopardized and investment decisions will likely be postponed, some of these probably even indefinitely in face of the extreme uncertainty entailed by Covid-19. The economic sentiment indicator plunged in Q1-20 and stands at its lowest level since 2010, and capacity utilization in manufacturing declined significantly from 76.8% in Q2-19 to 68.6% in Q2-20 (Q1-20: 74.1%).

Export growth is likely to reflect the development of Latvia's export markets, which will also face severe economic consequences in terms of contracting economic growth. Substantial declines in transport services and tourism expenses should severely dent services exports. Since import growth should also decline significantly, we expect net external trade to widen only moderately.

Against this background, we expect income convergence towards EU levels to experience a severe setback. We have witnessed persistent increases in per capita incomes over the recent years, supported by robust growth coupled with a steadily declining population (2015-2019: -3.3%). According to available IMF data, GDP per capita posted at USD 31,402 in 2019 (current prices, PPP terms), up by roughly 27% as compared to 2015, and standing at approx. 71% of the weighted EU average. However, per capita incomes may be deemed relatively low, judging by the 'A' median (USD 36,001), or GDP p.c. levels observed in its Baltic peers Estonia (USD 35,853, 81% of EU average) and Lithuania (USD 36,701, 82%).

At the same time, we have to reiterate our concerns regarding Latvia's growth potential in the medium to long term, which may put progress in income convergence towards Western European levels at risk, primarily due to demographic challenges and, to a lesser extent, potentially subsiding cost competitiveness. To be sure, we believe that potential growth will recover quickly and return to pre-Covid-19 levels over the medium term, aided by decent TFP growth (average 2010-19: 3.3%, AMECO data) and sustained capital accumulation (total investment average 2010-19: 22.0% of GDP, EA-19: 20.4%). It has to be mentioned that the pivotal Rail Baltica project has come under scrutiny, after having been significantly delayed over recent years, which may adversely affect investment. Tying into this, EU funds under the next Multiannual Financing Framework may come in lower, reflecting the UK's decision to leave the EU.

Latvia has exhibited solid labor productivity growth over the last five years, averaging at a relatively high 2.3% in 2015-19. We think, however, that productivity will come under considerable pressure going forward, prospectively driven by a significantly shrinking working age population given aging, migration, and spending on health, education, and social protection which is comparatively low from a European perspective. We are aware of notable government efforts devoted to these issues. Regulations pertaining to migration have been eased and, accompanied by progress in income convergence, have led to a slackened momentum in net migration. Although net migration is still negative, with roughly 3,360 people the 2019 outturn was the lowest over the last three decades (CSB data). Nevertheless, we recall that the old-age dependency ratio has been projected to leap to 43.2% by 2030 (2019: 31.7%, + 11.5 p.p.), and the Latvian working age to decline from 62.7% to 58.5% of total population over the same period (EU Aging Report).

Productivity may also be curtailed if unit labor costs (ULC) continue to rise unabatedly, attenuated by real wage increases unmatched by productivity growth, hurting the economy's cost competitiveness. While welcome from a convergence point of view, real compensation per employee rose strongly by 6.0% in 2019, and by 15.6% since 2016 (AMECO data). Thus, real ULC increased by 3.6% in 2019 as compared to a marginal 0.3% increase in the euro area as a whole, and 1.3% and 3.1% in Estonia and Lithuania respectively. At the current juncture, however, we see no signs of waning cost competitiveness, as suggested by our preferred measure, the global export market share, which has remained stable over the last years (2019: 0.08%).

In the same vein, non-cost competitiveness indicators appear to remain favorable, as Latvia continues to have one of the most welcoming business environments in Europe and fares well in a worldwide comparison. Latvia thus retained its good 19th rank in the latest edition of the World Bank's Doing Business assessment, with the enforcement of contracts (rank 15/190 economies), paying taxes (rank 16), and getting credit (rank 15) representing its main strengths.

Institutional Structure

Latvia's generally strong institutional framework constitutes a supportive pillar to our credit rating. The small, open country draws significant benefits from its deep integration into EU/euro area markets and structures, including access to a broad and deep capital market, the provision of considerable financial support via EU funding, and the application of common rules and standards that facilitate trade and enhance economic activity. With a view to the wider geopolitical situation, we would reiterate that unresolved political tensions between Russia and the EU, including ongoing sanctions, continue to leave Latvia exposed to some risk, given that the country is an immediate neighbor, although we would consider the probability of escalation as relatively low.

Above all, the sovereign's favorable institutional set-up is reflected in the latest set of the World Bank's Worldwide Governance Indicators (WGI), our preferred gauge for assessing institutional quality, although there remains some potential to catch up compared to the median of its A peers. Latvia is more or less on par with the latter when it comes to government effectiveness, i.e. the quality of policy formulation and implementation (rank 43/209

economies, A-median: 44), as well as to the WGI 'rule of law', which measures the quality of contract enforcement, property rights, and courts (rank 44, A-median: 43). At the same time, the country lags somewhat behind in terms of 'voice and accountability' (rank 52, A-median: 45). We are aware that the gap pertaining to the perception of control of corruption has widened, having deteriorated markedly from rank 64 to 75 (A-median: 59) in the latest WGI vintage – also standing below its Baltic peers Estonia (rank 22) and Lithuania (rank 66) in this regard.

Having said that, we note that a number of actions have since been taken to counter this impression. This would also include efforts to strengthen the effectiveness of the Corruption Prevention and Combatting Bureau (KNAB), the sophistication of the legal framework, and internal reporting mechanisms around whistleblowing. Moreover, at the end of April the Latvian Cabinet of Ministers approved an action plan which provides a roadmap for the next two years to enhance the fight against corruption, aiming to implement the recommendations of the OECD Anti-Corruption Working Group. The creation of a court for economic affairs, which was passed by parliament in mid-June and is to be established in 2021, represents another welcome step and could significantly accelerate judicial processes. We will continue to monitor developments on this front.

In the same vein, we pay attention to and assess positively recent communication related to progress on Latvia's regulatory framework for anti-money laundering and combating terrorist financing (AML/CFT). In a follow-up evaluation report to July 2018, when Moneyval identified compliance deficiencies with regard to relevant recommendations and standards set by the Financial Action Task Force (FATF); in January 2020 Moneyval attested the Latvian regulatory AML/CFT framework to be 'largely compliant' with 33 of the FATF's 40 technical recommendations, whilst being 'compliant' with the remaining seven. With that, Latvia was eventually not included on the FATF 'grey list' of countries that are under increased monitoring and are committed to cooperate with the FATF to address AML/CFT deficiencies, which would have been a severe blow to confidence in the sovereign's regulatory capacities and the Latvian financial sector more generally.

Looking at the current political set-up, we think that despite a more fragmented parliament and struggles to form a government after the 2018 election, the five-party coalition commanding 66 seats of the 100-seat parliament has demonstrated its capability to act in the present rather extraordinary circumstances, displaying the necessary cohesion. The above-mentioned progress concerning the implementation of structures to effectively prevent and fight AML/CFT may serve as further example of Latvia's commitment to sound and predictable policymaking.

Also, in a bid to strengthen accountability and efficiency of the public sector by transforming the existing 119 local governments into 42 municipalities, the administrative territorial reform was finally enacted this June and the new administrative structure will be applied from July 2021. We took note of a comment by the Rapporteur to the Council of Europe, suggesting that the reform might have benefited from checking against full conformity with the European Charter of Self-Government.

Fiscal Sustainability

Despite the substantial adverse effects of the Covid-19 pandemic, we view the sovereign's public finances as its key credit strength, reflecting a low public debt ratio, low financing costs, and prudent debt management which has kept public finances in check over the recent years, providing the sovereign with sufficient fiscal space to handle the Covid-19 crisis. However, the discretionary measures and the substantial revenue shortfall have altered its fiscal outlook decisively.

Last year, Latvia's budget was broadly balanced on the general government level, having narrowed to -0.2% of GDP from -0.8% of GDP in 2017 and 2018 respectively. The improvement came on the back of higher revenues, mainly due to net social contributions as well as VAT and personal income tax receipts, which rose by 10.3%, 7.5%, and 11.6% respectively (Eurostat, general government, consolidated data). Meanwhile, CIT revenues fell sharply by approx. 85% due to the previously implemented tax reform. Government spending, on the other hand, grew less vividly than nominal GDP, so that total general government expenditure was down from 39.5% of GDP in 2018 to 38.9% of GDP in 2019. While the public wage bill rose by 7.1%, public investment underperformed, falling from 5.5 to 4.9% of GDP.

Covid-19 will inevitably lead to a ballooning headline budget deficit this year, largely driven by automatic stabilizers and plunging tax revenues given the sharp economic downturn. The revenue side will be hit particularly hard, as the sovereign features a comparatively narrow revenue base, with PIT and VAT being the two pivotal revenue sources. As measured by GDP, total revenue stagnated at 38.7% in 2019, one of the lowest readings in Europe (EU-27 average: 46.2%). As pointed out in our past reviews, this is partly due to informal activities, which appear to remain pervasive in Latvia. As illustrated by the Shadow Economy Index compiled at the Stockholm School of Economics in Riga, the size of the shadow economy is estimated at 23.9% of GDP in 2019, having improved only slightly from 2018 (24.2% of GDP) and standing well above its fellow Baltic peers (Estonia: 14.3% of GDP, Lithuania: 18.2% of GDP).

Equally important, the Latvian government has initiated a raft of discretionary measures aiming to mitigate the adverse impact of the corona crisis in terms of safeguarding vulnerable groups, securing jobs, and preventing widespread insolvencies, putting additional pressure on its budget. The support package amounts to approx. 6.2% of GDP, of which roughly 3.1% of GDP should be treated as budget neutral at this stage, as these are made up of guarantees, i.e. working capital loans, credit holiday guarantees for SMEs and large business alike, and portfolio guarantees for SMEs.

The government adopted support measures such as a tax relief for roughly 1.2% of GDP, including an extension of tax payment deadlines (up to three years), the cancellation of PIT advance payments, and the refunding of overpaid VAT within 30 days. Furthermore, policymakers implemented viable income support initiatives geared towards families and vulnerable groups affected by Covid-19 (approx. 0.6% of GDP), e.g. benefits to families with no income, allowances for idle time, payment of the sickness benefit starting from the second day, an additional unemployment assistance payment, and supplements to child benefits. Also, sectors particularly affected by Covid-19 will receive substantial state support of

around 1.0% of GDP; among others, healthcare, cultural industries, agriculture and the aviation industry.

Taken together, we expect a pronounced budget deficit of 7.6% of GDP for the current year, which should decline considerably to more moderate levels in 2021. That said, we have to stress the unusually high level of uncertainty around these estimates, treating the approved and announced guarantee measures as one of the main downside risks to our budget forecast, alongside another round of support measures which would need to be implemented in the case of a second infection wave. New funds which may become available through additional financial support by the EU, i.e. via the so-called recovery fund, and might act as a cushion to some extent, if, drawing on figures provided by Brussels-based think tank Bruegel, grants amounting to EUR 2.9bn or 9.9% of 2021 GNI would be endowed to Latvia going forward. While obviously of minor importance at this stage, we nevertheless want to recall the rather medium- to long-term fiscal risks of increasing ageing costs stemming from the prospective rapidly-ageing workforce, and spending pressure related to health, education, and poverty.

Whilst the events surrounding Covid-19 thus interrupt the sovereign's fiscal consolidation path in the near term and entail extreme uncertainty with regard to fiscal prospects over the medium term, there is a confluence of risk mitigating factors which inform our stable outlook at present.

First and foremost, the sovereign entered the Covid-19 crisis in a favorable fiscal position, displaying a broadly balanced budget, a low public debt ratio, and low financing needs. At Latvia's 36.9% of GDP, down from 37.1% of GDP in 2018, general government gross debt was among the lowest in the EU-27 last year, and was on a declining path prior to the outbreak of the pandemic, supported by brisk economic growth and prudent fiscal policy-making. Looking forward, we assume that the public debt ratio will lie at some 49% of GDP in 2020 before stagnating on that level next year, and resume a gradual downward trajectory beyond 2021. Hence, public debt will remain relatively low compared to its European peers, remaining close to the pre-Covid-19 'A' median which stood at 46% of GDP in 2019.

Secondly, we view fiscal discipline as deeply rooted in the sovereign's policies, making prudent use of its fiscal space. Despite its increasingly fragmented political landscape and at times less stable governments (see above), fiscal sustainability and meeting the stipulated fiscal targets appears to have remained a top priority over the years. Accordingly, we assess the aid measures as largely appropriate and responsible from a fiscal sustainability point of view, being limited in time and scope and targeted towards the needs at hand. The sovereign's prudent debt management is reflected by a well-laddered redemption profile, with an average maturity of general government debt of 9.03 years (2019), whilst the share of foreign currency debt only amounted to approx. 5% at the end of Q1-20.

Thirdly, we believe that the sovereign's debt continues to be highly affordable, backed by low financing costs and high investor demand. Interest outlays declined to levels last seen before the Global Financial Crisis, equating to 1.8% of general government revenue in 2019 as compared to 1.9% in the preceding year and 3.9% in 2014. Debt sustainability risks are

further mitigated by the ECB's extraordinary monetary policy support. At its monetary policy meeting in June, ECB stepped up its initial Pandemic Emergency Purchase Program (PEPP) by EUR 600bn to EUR 1,350bn and extended it to at least the end of June 2021. Also, the ECB announced reinvestments of maturing principal payments from securities purchased under the PEPP until at least the end of 2022. The additional envelope of EUR 120bn to the APP until the end of the year remains in place, as do a number of measures to ensure liquidity to the banking sector, a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area, and measures to temporarily mitigate the effect of rating downgrades on counterparties' collateral availability.

We deem fiscal risks emanating from the financial realm to be limited at the current juncture, despite the dynamically evolving residential property prices and lingering reputational risks related to AML, mainly due to sound banking sector metrics. As highlighted by EBA data, the CET1 ratio increased further to 22.3% in Q4-19 (Q4-18: 21.2%), significantly above the EU average of 15.0%. In addition, asset quality continues to improve, with the NPL ratio equaling 1.9% at the end of 2019 (Q4-18: 2.8%), one of the lowest readings in Europe. We note that Bank of Latvia's (BoL) stress tests do not point to systemic risks. More generally, financial stability risks are limited due to the structure of Latvia's rather small banking sector (71.9% of GDP, ECB data), which is dominated by Nordic and domestic banks, with subsidiaries and branches of Nordic banks (SEB, Swedbank, OP) holding 49% of assets, while the rest of the banking sector mainly consists of two major Baltic bank groups (Citadele domiciled in LV and Luminor domiciled in EE) holding about 1/3 of the assets. Contagion risks appear mitigated by the large capital buffers, the relatively high profitability, and sound ownership structure of Nordic parent banks.

Housing prices continued to rise towards the end of last year. Based on OECD data, the three-year growth rate of real house prices amounted to 21.3% in Q4-2019, standing in double-digits since the end of 2017, also being driven by state support programs to foster house purchases. However, residential property prices appear to increase in tandem with household incomes, as reflected by a more or less flat price-to-income ratio. What is more, growth in housing loans is far from alarming. The same holds for anemic credit growth in general, which is more of a constraint for further economic development.

Despite government efforts and the credible commitment to impose stricter AML/CFT rules, we still see lingering reputational risks to the Latvian banking sector, echoing events around ABLV Bank and money laundering allegations. As a case in point, PrivatBank was fined EUR 1m for AML violations last year, although we would also regard this as evidence of a stringent application of AML/CFT rules. As a side note, ECB withdrew the banking license of the country's sixth-largest bank, PNB Banka, which was eventually declared insolvent and not resolved by the Single Resolution Board. What is more, authorities seemingly intend to make further headway in overhauling the financial sector, planning to streamline financial supervision by putting FCMC under the roof of BoL. The move is not expected to take place by 2022-23 and still has to be approved by parliament.

Challenges for banking sector stability and concomitant fiscal risks pertaining to the wind-down of the large volume of non-resident deposits seem contained, as the non-resident deposit banks, which are currently trying to adapt their business models, have no close

linkages to the domestic economy. Mirroring the significant transformation of the Latvian banking sector, the share of foreign deposits continued to fall, totaling 18.8% at the end of 2019, down from 53.4% in 2015 (FCMC data). Meanwhile, domestic and EU deposits now account for roughly 94% of total deposits as compared to 65% back in 2015, whereas the share of CIS and other third countries has dropped from 35% to a mere 6% in 2015-19.

Foreign Exposure

Our rating of the sovereign continues to be somewhat dampened by Latvia's external position, but we observe notable improvements. As a small, open economy (trade-to-GDP: 119.7%), Latvia essentially remains highly exposed to external risks, and Latvia's debt continues to be held mainly by non-residents. Posting at 83.6% at the end of 2019 (2018: 78.4%), the sovereign continues to display one of the highest ratios of general government external debt to general government gross debt in the EU – somewhat attenuated by the fact that government debt is among the lowest in Europe (see above). At the same time, gross external debt has diminished over recent years, coming down by 25.4 p.p. to 116.2% of GDP in 2017-19 – in parallel to rapidly diminishing deposits at the above-mentioned non-resident deposit banks. Thus, the share of deposit-takers in total external debt dropped from 30.0% in Q4-17 to 12.9% at the end of 2019, more than compensating for the increase in other sectors such as other financial corporations and general government, which saw their respective shares rising from 3.9 and 21.5% to 9.9 and 27.0% over that time span (QEDS data).

Accordingly, the country's relatively high and negative NIIP has shrunk further from -49.1% to -44.1% of GDP in 2018-19, continuing its narrowing trend in the aftermath of the Global Financial Crisis. The less negative position can be attributed to other investment, also reflecting the significant outflow of deposits, while the net inflow of both portfolio investment and direct investment had a widening effect on the NIIP. To this end, we recall that direct investment liabilities account for the bulk of the country's external liabilities (34.8% of GDP in 2019), thus moderating risks typically associated with a relatively high negative external position. Still, Latvia's NIIP remains relatively high compared to the other Baltics and CEE peers.

Latvia's current account deficit was again close to balance in 2019, coming to -0.5% of GDP (2018: -0.7% of GDP), as compared to a five-year average of 0.1% of GDP since 2015. According to latest Eurostat data, a relatively large deficit in goods trade (-8.1% of GDP) was more or less offset by the surplus in services trade (8.2% of GDP). While the goods trade deficit remained stable compared to the previous year, the services surplus increased somewhat owing to the persistent strength of services exports as discussed further above. Going forward, we would expect the current account to remain around a balanced position, given assumptions of corona-related steep declines in exports and imports this year.

Rating Outlook and Sensitivity

Our rating outlook for Latvia's long-term credit ratings is stable, as we see risks related to significantly weaker economic and fiscal prospects prompted by the corona crisis as

broadly balanced by the abovementioned factors mitigating fiscal risks in the short to medium term, and supported by our assumption of a deep but short recession. We note, however, that the assessment and interpretation of economic developments is subject to a substantially higher degree of uncertainty than usual, as is the case for other indicators, given the current considerable uncertainty in the economy and financial markets, and the constantly evolving news flow surrounding Covid-19 and its impact.

We could downgrade Latvia's credit ratings if we observe that the economic recovery is facing delays, e.g. in the event of a second Covid-19 infection wave, resulting in weaker-than-expected medium-term growth and a more protracted setback in income convergence. Downward pressure on the rating or outlook could also result from a sustained deterioration in public finances or a significantly widening current account deficit. A downgrade may also be considered if Latvia's cost competitiveness diminishes on a sustained basis, or if tensions between the EU and the Russian Federation were to escalate.

On the other hand, although relatively unlikely at this stage, we could raise Latvia's ratings or outlook if income convergence towards Western European levels accelerates, which could be the case if the Covid-19-related setback turns out to be less severe than expected and economic recovery is stronger than assumed in our baseline scenario. Upward pressure could also be prompted if public finances improve more rapidly than expected and the decline in the public debt ratio enters on a steeper downward trajectory, buttressed by fiscal consolidation.

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Ratings*

Long-term sovereign rating	A /stable
Foreign currency senior unsecured long-term debt	A /stable
Local currency senior unsecured long-term debt	A /stable

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019	2020e
Real GDP growth	1.9	3.3	1.8	3.8	4.3	2.2	-8.0
GDP per capita (PPP, USD)	23,550	24,692	25,684	27,646	29,912	31,402	n.a.
HICP inflation rate, y-o-y change	0.7	0.2	0.1	2.9	2.6	2.7	0.3
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	74.5	74.8	74.9	74.9	75.1	n.a.	n.a.
Fiscal balance/GDP	-1.6	-1.4	0.2	-0.8	-0.8	-0.2	-7.6
Current account balance/GDP	-2.3	-0.9	1.4	1.0	-0.7	-0.5	n.a.
External debt/GDP	143.7	142.7	148.4	141.5	122.9	116.2	n.a.

Source: International Monetary Fund, Eurostat, own estimates

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In what follows, we explain how and to which degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

ESG Factor Box

Environ-mental Quality	Ecological Risks	Ressource Management	Education	Health	**Demo-graphics**
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liber-ties/ Political Participation**	Market Access	Business Environment	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact

on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor 'Demographics' as significant since it has a bearing on the economy's potential growth.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	26.08.2016	A /stable
Monitoring	18.08.2017	A /stable
Monitoring	29.06.2018	A /stable
Monitoring	03.07.2019	A /stable
Monitoring	26.06.2020	A /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Treasury of the Republic of Latvia participated in the credit rating process as it provided additional information and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of the Latvian Treasury during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, Central Statistical Bureau of Latvia, Central Bank of Latvia, Republic of Latvia - Ministry of Finance, Ministry of Economic, Moneyval.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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